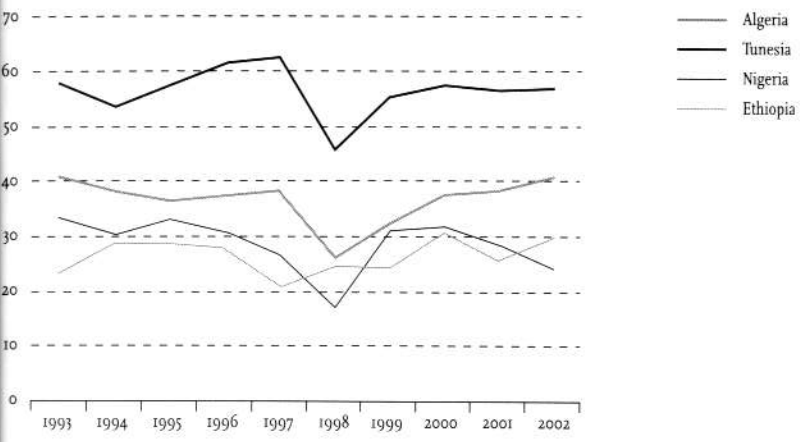
Country Risk Analysis

Figure 4.5 shows the rating for a number of African countries. The countries are characterized by low ratings (high risk), with Tunesia a notable exception. The low economic performance and the high political risk result in low ratings. The ratings do not vary as much as for the other countries that we have listed, although there was a decrease in 1998.

FIGURE 4.5
EUROMONEY RISK RATING FOR SELECTED AFRICAN COUNTRIES



Source: Euromoney, various volumes, 1993-2002

4.4 Conclusions

This chapter discusses the supply of country risk analyses by the credit rating agencies. In addition, we have discussed the methodology behind the construction of credit ratings. We conclude that most agencies provide similar types of products, based on similar variables. These variables have a close theoretical and empirical base because they closely coincide with the variables that we discussed in chapters 2 and 3. Finally we conclude that a very large number of variables have been included in the various types of ratings. Hence, the weight of individual variables is in general small and therefore the subjective element that is necessarily part of any rating system does not seem to cause much differences between the numerical values of the ratings. This also follows from the high correlations between the various ratings of the different institutions.

Banks and Country Risk I – External Environment

Chapters 1, 2 and 3 have defined country risk, the theoretical approaches to country risk analysis and the results of empirical research. Chapter 4 focused on the main suppliers of country risk analyses: what firms are the major suppliers and what data do they publish about country risk analysis?

Chapters 5 and 6 discuss the role that country risk plays for commercial banks, with the latter chapter focussing on the practical aspects of country risk analysis at banks. The current chapter gives an overview of the external environment of banks and kicks off with past experience of banks as regards cross-border lending. Subsequently, we describe the process of debt restructuring and the role of the London Club and the Paris Club. Debt restructuring has been necessary for some countries to limit the costs of (imminent) default. Next, we focus on the importance of the Central Bank, taking the Dutch banking sector as an example. Finally, we look at the role of the Bank for International Settlements, which plays a crucial role in the development of banking supervision. The conclusion summarizes the main findings of this chapter.

5.1 Development of Cross-Border Bank Lending

For a bank, and for other companies as well, country risk exists as soon as an activity crosses borders. To list a few examples: a domestic loan exposes a bank to credit, market and operational risk, where a loan to a debtor abroad also entails country risk. If a bank provides a local company with trade finance and the bank gets a claim on a foreign importer, country risk is also imminent. Moreover, the bank faces country risk if the bank provides loans to foreign banks via the interbank loan market and banks usually invest part of their wealth abroad, making part of their return subject to country risk. Execution of transactions on international capital markets could also suffer from country risk related events. An international network of branches further increases a bank's exposure to country risk, which could affect the branches' profitability and possibility of repatriation of profits.

Since the 1980s, the role of commercial banks within the cross-border financing framework has dramatically changed. Nowadays, cross-border bank lending is dominated by tailor-made instruments in the field of trade, bridge and project finance. Banks have also become a major party in the provision of liquidity and risk management tools to sovereign and corporate entities. Another major change since the 1970s is the current importance of short-term bank loans. These consist of trade credit, revolving credit facilities and term loans with a maturity of at most 12 months. A last development in cross-border bank lending is the crucial role of banks as main suppliers of over-the-counter derivatives like cross-border swaps, forward swaps, caps and swaptions.

In the 1970s, cross-border bank loans concerned mainly long-term loans, which were often syndicated. Commercial banks formed strong coalitions and used strict loan covenants. Borrowers which would get into default were threatened by exclusion from further foreign bank loans. According to Chadha and Folkerts-Landau (1999), the united stance of bank creditors towards cross-border debtors raised the cost of default so much that the view arose that 'countries don't default'.

In August 1982, Mexico got into a liquidity crisis and was not able to fulfill all of its external payment obligations to banks, thereby ending the popularity of the aforementioned view. Subsequently, payment arrears on bank loans to other (Latin American) countries arose, sometimes as a consequence of a national suspension of foreign payments or milder transfer restrictions. Van Eekelen (1988) has shown that the twelve largest US banks had a dangerously large portfolio of unsecured medium and long-term loans to developing countries in 1983. Medium and long-term loans to these countries by ten banks exceeded the equity of these banks substantially. Until 1983, US banking legislation pointed out that exposure on a single debtor (or group of mutually related debtors) should be at most 10% of the equity of an individual bank. Van Eekelen stated that US banking supervisors had failed to apply the rules to exposures on foreign sovereign entities, because maintaining good international relations and promoting US exports took priority. Moreover, banking legislation failed to take into account country risk, thereby enabling the build-up of high banking exposures as regards Argentina, Brazil, Mexico and Venezuela in the 1970s. These bank experiences explain the importance of country risk within banking supervision legislation, which we will further discuss in section 5.3. As banks with outstanding loans to countries in default easily get involved in difficult negotiations to restructure debt (as happened in the 1980s), we focus on the London Club and the Paris Club in the next section.

5.2 Debt Restructuring

The London Club has played an important role in past debt restructuring deals between sovereign debtors and commercial creditors (mainly banks). In general, debt restructuring could either lead to a more favorable repayment structure for the debtor, while keeping principal amount and interest rate unchanged[28] or to a reduction of the principal repayments and/or interest rate. Moreover, debtor and creditor can agree to suspend repayments for a certain time, the so-called *grace period*. A debt restructuring deal is attractive for a bank or another foreign creditor if the repayments of the troubled debtor are expected to be higher after the deal becomes effective than in a situation without a restructuring agreement. Moreover, it can be more convenient to have exposure on a debtor that gets fully repaid than to deal with continued payment arrears of that debtor.

The Paris Club also aims to smooth the debt restructuring process for countries with (imminent) external payment difficulties. So the Paris Club's aim is comparable to that of the London Club, but its members are bilateral creditors (governments). The importance of the Paris Club for banks originates in its 'comparability of treatment principle', which aims to equally spread the costs of debt restructuring over all the various types of creditors of the sovereign

BOX 6

THE LONDON CLUB AND THE PARIS CLUB

The International Institute of Finance (IIF, www.iif.org) describes the London Club and Paris Club as follows:

The London Club. By the 1970s, countries facing default were using what became known as the London Club process to restructure sovereign debt owed to commercial banks. The London Club has evolved as an ad hoc forum for restructuring negotiations. Each London Club is formed at the initiative of the debtor country and is dissolved when a restructuring agreement is signed.

The Paris Club. Since 1956, countries facing default have negotiated debt-restructuring arrangements with bilateral official creditors in the Paris Club, an informal body created for the purpose of maintaining strict standards for rescheduling or reducing debt. The Paris Club currently has 19 member countries, all of which are members of the OECD except for Russia. The French Ministry of Finance serves as a Secretariat to the Paris Club, and all negotiations with debtor countries are held in Paris.

28 Although the total repayable amount remains the same, the creditor suffers a loss from this construction as the Net Present Value (NPV) of the loan decreases as repayments occur at a later point in time.

In The Netherlands each credit institution is obliged to keep its country risk management systems in line with the targets of the DNB country risk policy, which is looking backward and forward at the same time in the sense that this policy deals with both actual country risk related payment arrears and with the likelihood of future payment arrears. The DNB policy focuses on exposure of Dutch credit institutions to counterparties established abroad, except for a number of industrial countries.[30] DNB makes a distinction between major and minor countries, whereby the share of a country in the gross exposure of the combined Dutch supervised institutions determines the status of that country. If the share of a country in the aggregated gross exposure[31] of Dutch credit institutions exceeds 1%, this country is labelled a 'major country', all those that stay below 1% are 'minor countries'.[32] DNB requires commercial banks to report their foreign exposures twice a year. Furthermore, banks need to report their exposure on a quarterly basis to the Bank for International Settlements (BIS).

Although DNB states that country risk management is primarily the responsibility of the management of the credit institution, DNB formulates explicit capital and provisioning requirements for country risk to foster financial stability. Four times a year DNB consults the commercial banks about provisioning rules for international exposure. Normally, DNB sets a provisioning rating for all major countries in co-operation with the Dutch Banking Association twice a year, unless exceptional developments require an interim change. The categories for major and minor countries range from 'nil' and 'low' to 'medium' and 'high', whereby commercial banks classify minor countries themselves. A 'nil' rating means that a bank does not need to keep additional provisions for cross-border exposure. In this case the exposure on a country is treated as domestic exposure, which implies no capital requirements for country risk and an 8% capital requirement for credit risk. The risk categories 'low' or 'medium' imply substantial country risk without an acute threat of repayment problems, depending on the severity of the country risk. For countries with a 'low' category, a bank has to meet additional capital requirements in a range of 50-150% of the required capital for credit risk, depending on the country risk rating of the bank.[33] The 'medium' category implies additional capital requirements in a range of 150%-250%. A 'high' rating points to an acute threat of repayment problems or actual repayment problems. Due to considerable country risk, commercial banks face a relatively high additional capital requirement for the country risk of at least 300%.

30 Countries belonging to the Group of Ten and/or the European Economic Area, Australia, New Zealand and Singapore. These countries are assumed to be virtually free of country risk.

31 Gross exposure is equal to total exposure minus local currency commitments minus risk shifted amounts, to be explained in further detail in section 6.3.

32 Exceptions on this rule do exist and can be found in DNB (2002), under 4091-02.1.1.

33 So, if a country necessitates an additional capital requirement against country risk of 150%, the total required capital is 20% of the transaction value (8% for credit risk and 8%*150/100=12% for country risk).

According to DNB (2002), total exposure on a country is 'the aggregate exposure to counterparties established in a single country'. Total exposure comprises, next to receivables and off-balance-sheet instruments, the so-called *secondary country risk exposure*. Exposure to a foreign subsidiary or a branch of a bank is also booked on the parent bank's country, if the latter is established outside the country of the debtor. Secondary country risk exposure needs to be reported by Dutch banks, as liquidity problems in the country of the parent bank could make this bank transfer funds from the branches or subsidiaries abroad, thereby possibly deteriorating the country risk of countries where the funds are transferred from. As an exception, DNB does not consider exposure on Dutch branches or subsidiaries of foreign banks secondary country risk.

Gross exposure is equal to total exposure, but excludes commitments in the national currency of the counterparty (local currency) and exposure, that has been shifted to a third party outside the country of the counterparty. Risk shifting is only possible for foreign receivables and off-balance-sheet instruments, like forward foreign exchange contracts. An example of risk shifting is a hard guarantee of a mother company of the (non-bank) counterparty, established in another country. Risk shifting also takes place when an export credit insurance company (e.g. Gerling NCM in the Netherlands) covers a part (possibly up to 98% of transaction value) of the country risk of a certain transaction. Banks then consider only the uncovered part of the transaction as gross exposure.

Net exposure equals gross exposure minus a number of deductible items. If a bank has already made provisions for loan losses, these provisions are not included in net exposure. Moreover, if the country risk of certain commitments is smaller than that of other exposure, a bank is allowed to calculate only a percentage of the exposure of the relatively safe transaction (so-called *risk weighting*). For example, the probability of repayment in times of an external liquidity crisis is relatively high for food related import loans, as countries need to safeguard the domestic food supply. Under certain conditions, a bank could decide to reduce the amount of a pre-export finance transaction to be booked under the country limit as the risk of this transaction is lower than with common export finance. Risk-weighting is also possible if a bank participates in a transaction together with a multilateral institution with preferred creditor status.

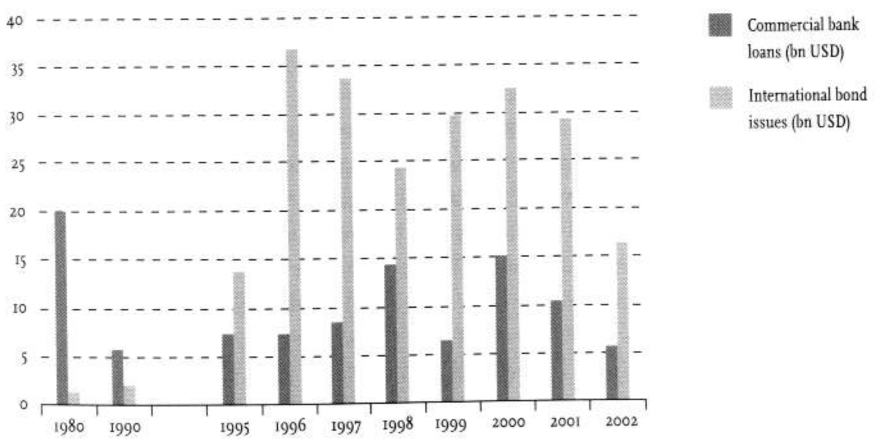
entity. The Paris Club explains this clause on its website as follows: '(...) the debtor country commits itself to seek from non-multilateral creditors, notably other official bilateral creditor countries that are not members of the Paris Club and private creditors (mainly banks, bondholders and suppliers), a rescheduling on comparable terms (...)'. In general, short-term trade finance is not included in Paris Club deals to avoid interruptions of trade flows. Creditors, whose exposure is very small in terms of the total foreign obligations of the debtor, can be excluded from the restructuring agreements of the Paris Club.

The number of past debt restructuring treatments and the terms of these treatments can be considered as indicators of country risk. Countries which have concluded relatively many deals with the London Club and/or the Paris Club do probably have a structurally weak balance of payments position. Following the same logic, a country that gets more time to repay its debt to London/Paris Club creditors without any debt write-off clearly has a better repayment capacity in foreign currency terms than a country that gets a 90% debt write-off.

Figure 5.1 shows that the relative importance of bank loans as an external financing source for the public sector in Latin America has decreased at the benefit of international bond issues. More general, international capital markets have gradually gained popularity in Emerging Markets at the cost of banks to provide governments and corporates with medium and long-term, non-local currency funds. This development has made the coordination of creditors in case of a possible debt restructuring much harder. According to the IMF (2003), the situation is further complicated by the diversity in financial instruments and legal jurisdictions under which debt is issued.

FIGURE 5.1

EXTERNAL FINANCING SOURCES OF THE PUBLIC SECTOR OF LATIN AMERICAN AND THE CARRIBEAN COUNTRIES



Source: Global Development Finance, eds. 2000 and 2003, World Bank

Currently, the international financial community is engaged in a discussion how to improve the debt restructuring process. The first much-discussed alternative is the so-called *collective action clause* (CAC). These CACs state that a majority of holders of a certain sovereign bond can make their restructuring proposal binding for all holders of that one bond. An alternative for the CACs is the so-called *Sovereign Debt Restructuring Mechanism* (SDRM), which can be seen as a CAC for all sovereign debt titles. The main quality of this mechanism is that the preferred debt restructuring proposal of a certain minimum majority of creditors and the debtor is binding for all creditors of the sovereign. Moreover, SDRM also includes the possibility that a majority of creditors can approve new loans to the sovereign to smooth the restructuring process. The IMF (2003) further states that 'the SDRM would provide an impartial dispute resolution process to protect creditors against fraud' and 'the SDRM would enter into force for all countries at the same time'.

5.3 The Role of the Dutch Central Bank (DNB)

As we have seen in section 5.1, a central bank is a crucial part of the external environment of commercial banks. In The Netherlands, De Nederlandsche Bank (DNB) is among other things responsible for the supervision of the banking sector. With respect to country risk, the policy of DNB aims to ensure both adequate country risk management by the supervised institutions and adequate financial buffers against country risk exposure. The definition of country risk that DNB uses is very close to the definition that we have used throughout this book. Country risk is 'the risk on a consolidated basis of (1) a foreign public authority failing to meet its obligations (sovereign risk) and/or (2) a foreign public authority placing restrictions on funds transfers from other debtors in its country to foreign creditors (transfer risk) and/or (3) a large number of debtors in a single country being unable to meet their obligations owing to a single cause (collective debtor risk)'.[29]

29 DNB (2002), 4091-02.1

The Bank for International Settlements (BIS)

The Bank for International Settlements (BIS) is the organization of central banks of industrialized countries, but functions as a discussion platform for central bankers from all around the world. Furthermore, BIS acts as 'a bank for central banks' and aims to limit monetary and financial instability in national and international financing. Therefore, BIS has its own research departments and can act as an agent in financial transactions. Moreover, central banks have the opportunity to use BIS as counterparty in financial operations. BIS also collects and publishes economic and monetary statistics, which means that commercial banks in BIS-countries must report their exposure on a quarterly basis to BIS. BIS also promotes international financial stability by establishing supervision rules for central banks. Many central banks, also of non-member states, set their regulatory framework in line with BIS rules. Therefore, the developments within BIS are very important for all banks, inside as well as outside the BIS area.

In 1988, BIS introduced the so-called *Basel capital requirements*, which aimed at improvement of banking supervision. These requirements focused on credit risk, which included country (transfer) risk. In 1996, an amendment to the original agreement extended the scope of capital charges to market risk as well.

The Basel capital accord of 1988 (Basel I) required commercial banks to keep at least 8% of their exposure, including cross-border claims, in the form of capital. To cope with differences in risk between the various assets it was decided to risk-weight the various types of assets. Thus the risk perception of a claim could result in a reduced or increased weighting of a transaction, which means that the final capital requirement could deviate from 8%. In case of claims with very low weights (*e.g.* claims on governments), exposure will be lower than the nominal value of the claims and hence the capital requirement will be below 8% of the nominal value of the claims. Basel I stipulated that the weighting of a claim depended on the type of the debtor (government, bank or corporation), on the maturity of the transaction (short-term or long-term) and on the OECD-membership of the country involved. Examples of engagements with a low weighting are collateral backed loans (mortgages) and transactions with third party guarantees.

In April 2003, BIS published the third version of a consultative document 'The New Basel Capital Accord' (hereinafter 'Basel II'), which deals with a new capital adequacy framework.[34] The goal of the responsible BIS committee, the Basel Committee on Banking Supervision, is to present the final text of the accord by the end of 2003. Member countries are expected to implement the new capital requirement rules by the end of 2006.

This new capital adequacy framework consists of three pillars: minimum capital requirements, principles for the supervisory review process and public disclosure requirements to enforce market discipline. Basel II introduces capital requirements for operational risks and leaves the treatment of market risk unchanged. In line with the scope of this study, we will concentrate on the first pillar (minimum capital requirements) and on credit risk, which includes country risk. The second consultative document states that '[b]anks should take all relevant information into account in assigning ratings to a borrower. (...) As a minimum, a bank should look at (...) the risk characteristics of the country [the borrower] is operating in, and the impact on the borrower's ability to repay (including transfer risk), where the borrower is located in another country and may not be able to obtain foreign currency to service its debt obligations.'[35]

The introduction of Basel II will increase the risk sensitivity of new capital requirements substantially. The risk-weighting procedures for credit risk are expected to be more effective and to enable a more comprehensive look at capital requirements. Banks can choose between the standardized approach and the internal ratings based (IRB) approach to credit risk. The former approach is a modified, more risk sensitive version of Basel I, including an adjustment of the risk-weighting percentages. According to this approach banks should use external country risk ratings to determine economic capital allocations. In contrast with Basel I, the standardized approach does not include sovereign cap, implying an end to the practice where the sovereign rating of a country is by definition the best rating in that country. This change is proposed as some private entities such as multinational or export-oriented companies have better access to foreign exchange than the public sector in some countries. Furthermore, the standardized approach allows banks to give local currency claims on the sovereign a zero weighting as the sovereign controls domestic money supply while not having the same privilege for foreign currency. Basel I made a difference between OECD-governments and non-OECD-sovereigns, as claims on the former did not necessitate capital (zero risk-weighting), while claims on the latter had a 100% risk weighting. The standardized approach abolishes this differentiation, which means that bank loans to certain OECD-sovereigns will require more capital. Basel I applies to short-term cross-border loans a risk weighting of 20%, which implies a capital requirement of 1.6% for external

Note that the second consultative document was published
nuary 2001.

35 BIS (2001a), paragraph 265, page 51.

loans with a maturity of less than one year. The new capital accord proposes to increase the risk-weighting percentage to 100% for most emerging markets under the standardized approach. This increases the solvency requirements for country risk.

The IRB approach enables banks with well-developed, advanced country risk management systems to use their own ratings for the determination of allocated economic capital. The IRB approach differentiates between two sub-approaches. The foundation approach states that the bank determines default probability based on own estimations, while the loss given default (LGD) calculation is done with the help of pre-set weightings. The other IRB-approach is the advanced approach, which enables banks to set the LGD themselves. If banks want to use the last approach, they need to make clear to their central bank that their country risk management systems are sufficiently developed to deal with all matters that are necessary for this approach. Many banks will therefore favor the foundation approach at the introduction of Basel II. This would be unfavorable for banks with below average past losses on their portfolio and for banks with products with a below average LGD. The standardized and IRB foundation approach only differentiate products to a limited extent, while the advanced approach allows banks to use their own internal estimates for LGD.

Emerging markets with below average ratings will suffer from the introduction of the Basel II capital requirements, as banks will need more economic capital than before to provide loans to entities in these countries. The same holds for governments of OECD-countries, to which Standard&Poor's has assigned a rating worse than AA-[36]. A potential danger of the new capital requirements is their amplifying effect in case of a deteriorating country risk profile. Banks would then lower their ratings, implying higher capital requirements and less appetite for loans to the country involved, further increasing the country risk. The abolishment of the sovereign cap would be favorable for companies and banks with an above average external liquidity in countries with a relatively bad country risk rating.

5 Conclusions

In the 1980s, the default of a number of sovereign entities in particularly Latin America marked the beginning decline of the role of medium and long-term bank loans to the benefit of international bond issues. Banks gradually became more active in trade, bridge and project finance, while banks also provided more and more liquidity and risk management tools. The rise in short-term bank loans and over-the-counter derivatives further illustrates the changed role of banks in cross-border lending.

Particularly since the 1970s, the London Club (commercial creditors, mainly banks) and the Paris Club (bilateral official creditors) have rescheduled the foreign debt of a number of sovereigns. The coordination between holders of different sovereign debt titles has become difficult due to the grown diversity of cross-border debt instruments and creditors. To improve this coordination, a discussion within the international financial community has arisen. Collective Action Clauses (CACs), which state how a restructuring of payments on a single bond should be arranged, and the Sovereign Debt Restructuring Mechanism (SDRM), which consists of rules to restructure the whole sovereign debt at once, have recently received much attention.
The country risk policy of De Nederlandsche Bank aims to ensure adequate country risk management by supervised institutions and adequate financial buffers against country risk exposure. Although DNB states that country risk management is primarily the responsibility of the management of the credit institution, DNB formulates explicit capital and provisioning requirements for country risk to foster financial stability.

In April 2003, the Bank for International Settlements (BIS) published the third consultative document about new rules for capital requirements (Basel II). Basel II aims at making the risk-weighting procedures more effective and enables a more comprehensive look on capital requirements. Banks can choose between the standardized approach, which is a refinement of the current BIS rules, and the internal ratings based approach, which allows banks to use their own country risk management systems to determine their required capital.

See Bank for International Settlements (2003, pages 6 and
atings of other external credit assessment agencies may be
d as well.